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Government Green Paper published: the pace of corporate governance reform accelerates

An overview of the Government's Green Paper and other corporate governance reforms.

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Who remembers the consultations before the Companies Act 2006 (the so-called "Green Bricks") and the debate about whether directors should be promoting the success of the company while taking into account the interests of stakeholders and the impact of their decisions in the long term and on the community and the environment, the so-called "enlightened shareholder value" approach. Or, should directors follow the plural interests of the company and its stakeholders - a pluralist approach. Ten years on from that Act, companies are facing a deluge of potential corporate governance reforms as the UK Government (and others) place greater scrutiny on corporate behaviour and, in particular, on executive pay, diversity and gender balance and worker and consumer representation on boards.

The Government published a Green Paper on corporate governance reform on 29 November 2016. This Green Paper "focusses on ensuring that executive pay is properly aligned to long-term performance, giving greater voice to employees and consumers in the boardroom, and raising the bar for governance standards in the largest privately-held companies." All of which may lead to fundamental changes in these areas.

The Green Paper sets out the problems that the Government want to tackle and various potential options for solving the problems. The Government states that, at this stage, it does not have preferred options. The responses to the Green Paper will be used to help the Government understand the strengths and weaknesses of the different options and build a better evidence base before deciding which of them to develop further. Comments are due by 17 February 2017.

This follows the BIS House of Commons Select Committee inquiry on corporate governance which focusses on executive pay, directors' duties and boardroom composition, including worker representation and gender balance in executive

"And I want to see changes in the way that big business is governed. The people who run big business are supposed to be accountable to outsiders, to non-executive directors, who are supposed to ask the difficult questions, think about the long-term and defend the interests of shareholders."
"In practice, they are drawn from the same, narrow social and professional circles as the executive team and - as we have seen time and time again - the scrutiny they provide is just not good enough. So if I'm Prime Minister, we're going to change that system - and we're going to have not just consumers represented on company boards, but employees as well."

positions. The Committee inquiry follows on from the corporate governance failings highlighted by the Committee's recent inquiries into BHS and Sports Direct.

(Theresa May, Birmingham Speech, 11 July 2016)

Government proposals for corporate governance reform

Theresa May had said that the UK Government will consult on "measures to tackle corporate irresponsibility - cracking down on excessive corporate pay and poor corporate governance, and giving employees and customers representation on company boards." (G20 speech, 05 September 2016)

The Green Paper states that its aim is "to consider what changes might be appropriate in the corporate governance regime to help ensure that we have an economy that works for everyone." It focusses on three specific aspects of corporate governance:

- executive pay
- strengthening the employee, customer and supplier voice, and
- whether the UK's largest privately-held companies - where they are of similar size and economic significance to public companies - should be expected to meet certain minimum standards of corporate governance.

Executive pay

Giving shareholders greater voting and other rights - shareholders of listed companies currently have a binding vote on the company's remuneration policy every three years (or earlier in certain circumstances) and directors can only be paid in accordance with the approved remuneration policy.

Shareholders also have an annual advisory vote on the report which describes how the prior year's remuneration policy has been implemented. If the advisory is lost, the company has to put its remuneration policy to a binding vote at the next AGM (or earlier).

The Government is considering whether shareholders need stronger powers to improve their ability to hold companies to account on executive pay and performance and, if so, which of the options in the Green Paper are supported. The options are:

- A binding vote on all or some elements of the executive pay package. This could be the full remuneration report or refer only to variable pay elements of the pay award (such as the annual bonus, the Long-Term Incentive Plan and any proposed increase in basic salary). It could be applied annually to all companies or only to companies that have encountered significant shareholder opposition to the remuneration report.

  It could include an escalation process whereby a binding vote would only be required if a "significant minority" opposed pay awards in a particular year. This is an approach which is supported by the Executive Remuneration Working

Group in its Final report on executive remuneration and the Big Innovation Centre in its Interim Executive Remuneration Report.

- Introduce stronger consequences for a company losing its annual advisory vote on the remuneration report - for example, the company could be required to win the backing of a "supermajority" of shareholders (eg 75%) to approve the next pay policy or there could be a requirement to hold a binding vote on pay the following year.

- Require or encourage quoted company pay policies to (a) set an upper threshold for total annual pay (from all elements of remuneration), and (b) ensure a binding vote at the AGM where actual executive pay in that year exceeds the threshold.

- Require the existing binding vote on the executive pay policy to be held more frequently than every three years, but no more than annually, or allow shareholders to bring forward a binding vote on a new policy earlier than the mandatory three year deadline.

- Strengthen the UK Corporate Governance Code to provide greater specificity on how companies should engage with shareholders on pay, including where there is significant opposition to a remuneration report.

Encourage shareholders (institutional and retail) to use any powers they have - stronger shareholder voting rights on pay will only have an impact if shareholders are prepared to cast their votes, and to use them, where necessary to vote down pay awards that they consider are unjustified. The Government is considering:

- requiring mandatory disclosure of fund managers' voting records at AGMs and the extent to which they have made use of proxy voting
- requiring companies to establish a senior "shareholder" committee to engage with executive remuneration arrangements, and
- providing ways to facilitate or encourage individual retail shareholders to exercise their rights to vote on pay and other corporate decisions.

Remuneration committee role - the Government is asking for views on whether steps need to be taken to improve the effectiveness of remuneration committees, and their advisers, in particular to encourage them to engage more effectively with shareholder and employee views before developing pay policies. The possible options are to:

- require the remuneration committee to consult shareholders and the wider company workforce in advance of preparing its pay policy, and
- require the chairs of remuneration committees to have served for at least 12 months on a remuneration committee before taking up the role, as proposed by the Executive Remuneration Working Group.

Transparency in executive pay - companies currently have to produce a single annual pay figure for each member of the executive board; the remuneration report has to compare the annual change in the CEO's salary to the annual change to the median salary in the company; and companies must disclose the performance targets which trigger bonus awards (but can withhold them where the company regards them as commercially sensitive). The Government wants to explore whether there is additional information which companies could provide which would make shareholders more effective in holding boards to account on their executive pay arrangements.

One option is to require companies to publish the ratio between the CEO's pay and the average pay of employees. The Government has noted the pros and cons of this proposal, including that it could produce misleading results and is therefore seeking views on whether a new pay ratio reporting requirement should be introduced, and, if so, what form of reporting would be most useful.

The other issues it is considering are (i) whether the existing, qualified, requirement for companies to report the performance targets that trigger annual bonuses and benefits under long-term incentive plans should be strengthened; and (ii) how long-term incentive plans could be better aligned with the long-term interests of quoted companies and shareholders.

Worker/consumer directors

Theresa May had originally said that she would be looking to have employee and consumer directors on boards. She then clarified that this proposal "is not about mandating works councils, or the direct appointment of workers or trade union representatives on boards" but more about "other routes that use existing board structures, complemented or supplemented by advisory councils or panels, to ensure all those with a stake in the company are properly represented." (Theresa May, speech at the CBI Conference, 23 November 2016)

The Green Paper now puts forward several possible options which are:

- stakeholder advisory panels - for directors to hear directly from their key stakeholders and amplify voices with different backgrounds and perspectives to those more commonly found in the boardroom
- designating existing non-executive directors to ensure that the voices of key interested groups, especially those of employees, is being heard at board level
- appointing individual stakeholder representatives to company boards - the Government is not proposing to mandate employee/consumer directors, and
- strengthening reporting requirements related to stakeholder engagement.

Women on boards

The Green Paper also notes that these improvements to corporate governance sit alongside the recent work that Sir Philip Hampton and Dame Helen Alexander are

"The review will focus on ensuring the very best of female talent make their way up the pipeline by doing to increase gender diversity in the boardroom and in senior management and Sir John Parker's work to consider how to improve ethnic diversity.

removing barriers to their success, and continue to drive forward the momentum from Lord Davies's work - which pushed the numbers of females on FTSE 100 boards up from 12.5% to 26%."
Hampton/Alexander review

Hampton-Alexander review

Momentum had been building to move to the next target recommended by Lord Davies in his final report , of all FTSE 350 boards having 33% female representation by 2020 and to ensure greater representation of women at executive levels.

On 07 July 2016, the UK Government announced the appointment of Sir Philip Hampton and Dame Helen Alexander to head a group to carry out an independent review on improving female representation at executive level in FTSE 350 companies and raising the target to 33% of women on boards by 2020.

The Hampton-Alexander Review's report (published on 09 November 2016) makes various recommendations including that FTSE 350 companies should have aim for a minimum of 33% women's representation on their boards by 2020; FTSE 100 companies should aim for a minimum of 33% women's representation across their executive committee and in the direct reports to that committee; and all stakeholders should work to ensure increasing numbers of women are appointed to the roles of chair, senior independent director and executive director positions on boards of FTSE 350 companies. (See "Representation of women - focus on the pipeline" for more details).

"We are launching the next stage in the journey where FTSE 100 companies will aim for a third of their all-important leadership roles to be occupied by women by the end of 2020."
Hampton - Alexander report

Women in Finance Charter

On 08 November 2016, HM Treasury announced that 93 firms across the financial services sector had signed the Women in Finance Charter. The first signatories were announced in March 2016 and joined by a further 22 in November 2016. These firms have committed to promote gender diversity by:

- having one member of its senior executive team who is responsible and accountable for gender diversity and inclusion
- setting internal targets for gender diversity in senior management
- publishing progress annually against these targets in reports on their website, and
- having an intention to ensure the pay of the senior executive team is linked to delivery against these internal targets on gender diversity.

As part of their commitment to the charter, the first signatory firms have also set and reported their gender diversity targets to HM Treasury. These show that of the first 72 firms, 60 have committed to having at least 30% of women in senior roles by 2021 - this includes 15 banks and 13 leading insurers who together employ over 375,000 people in the UK. Thirteen organisations, including Virgin Money, the Financial Conduct Authority and Legal and General, are aiming for complete gender parity in senior roles - a 50/50 split. (See "New signatories to the Women in Finance Charter" for more details.)

And, more recently, certain funds have pledged to vote against boards that do not have enough women executives.

Further transparency around women in the workplace and diversity generally is due in 2017 as companies will have to include a description of the board's diversity policy in the company's annual report and will be required to disclose publicly pay differentials and where women fall within the organisation's hierarchy as a result of the introduction of gender pay reporting by large employers. (See "Gender pay gap reporting - first snapshot of data by 2017" for more details.)

Ethnic diversity on boards

Ethnic diversity on boards has also now moved to the top of the agenda following the Parker Review report which found that FTSE boards "do not reflect the ethnic diversity of the UK". The report makes various recommendations including that: each FTSE 100 Board should have at least one director of colour by 2021, and each FTSE 250 Board by 2024; and FTSE 100 and 250 companies should develop mechanisms to identify, develop and promote people of colour within their organisations to build a pipeline of Board capable candidates and to ensure that their managerial and executive ranks appropriately reflect the importance of diversity to their organisation. (See "One by one: the case for ethnic diversity in the Boardroom")

Our view

The number of new reports, guidance, measures and disclosures is considerable, and all involve key aspects of corporate conduct. This, it seems to us, reflects a continuing determination within society for companies to act in a socially responsible manner and to achieve long-term sustainable success for the benefit of all stakeholders, not just the shareholders. The Green Paper is welcome as it addresses the broader debate of how companies should best take into account the interests of stakeholders.

So, now seems timely to reflect on whether the model of enlightened shareholder value that underpins directors' duties (as codified by the Companies Act 2006) is still fit for purpose. While we still do not advocate a pluralist approach it seems to us that the duty of directors to have regard to the likely consequences of any decision in the long-term could more explicitly, and better, refer to "sustainable" long-term outcomes; and the interests of the company's employees should refer to employees "and their pension entitlements".

The debate is much more fundamental. After all, as research quoted by the FRC in their report on culture showed, intangible assets such as intellectual property, customer base and brand now account for over 80% of corporate value, compared to under 20% 40 years ago.

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